The best economy in the east

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Abstract:
Kazakhstan led the world growth table in 2001 and credit rating agencies see it as a sound candidate for borrowing. Export credit agencies are not so confident, pointing in their ratings to paltry political reform and a nepotistic ruling elite. The US started the ball rolling in March when it recognized the country as a "market economy." A winning combination of a new pipeline that has opened up oil exports to international markets and some of the most progressive reforms in the CIS is the bedrock of the republic's success. Over the past few years Kazakhstan has put in the best performance of all the countries of the CIS. Despite having a strong claim to "best economy in the east," Kazakhstan is nowhere near winning "the best run country of the year." Export credit agencies rate Kazakhstan as a category 6 country, a poor reliability rating.

Full Text:

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Kazakhstan

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IT'S OFFICIAL: KAZAKHSTAN has a working free-market economy and it is booming. A string of announcements over the past few months has made the central Asian republic's economy the darling of international institutions and superpowers.

The US started the ball rolling in March when it recognized the country as a "market economy". It is a label that Washington has been reluctant to bestow on many of the countries of the former Soviet Union because of complaints by producers at home. Most of the former Soviet states are big exporters of cheap raw materials, produced at below-market costs thanks to what is effectively free power.

In part US recognition was a political payoff for Kazakhstan's support of the US-- led antiterrorist operations in Afghanistan but it is also hard to ignore the country's rapid return to robust health. The Kazakhstan economy has shone in the past two years - and not just by comparison with the basket-case economies in the region. It's far more impressive than that: in 2001 Kazakhstan's 13.2% GDP growth was the world's best.

The World Bank also believes that the economy had left the intensive care ward. Bank vice-president Johannes Linn said earlier this year that the Kazakh economy "does not give grounds for serious concern" and that the Bank regards Kazakhstan as "a key state" capable of exercising a serious influence on the economic development of the whole region.

A few months later all this optimistic rhetoric was backed up by something a little more practical. At the start of July rating agency Standard & Poor's upgraded Kazakhstan to BB+ status. The rating is one step away from the coveted investment-- grade rating of BBB, which will open the country to a whole new class of investor.

A winning combination of a new pipeline that has opened up oil exports to international markets and some of the most progressive reforms in the CIS (Commonwealth of Independent States) is the bedrock of the republic's success.

Over the past few years Kazakhstan has put in the best performance of all the countries of the CIS. Banking and pension reform is largely completed (see separate article), a capital amnesty along with a trustworthy banking system has brought both flight capital home and mattress money into the formal economy. Small and medium-size enterprises are flourishing.

However, the global economic malaise and Russia's slowdown in particular - has put the damper on growth this year. In March president Nursultan Nazarbayev announced that growth had slowed to 10% over the first quarter and warned that the republic was unlikely to end the year with growth above 4%, down from earlier estimates of 7% for the year. Likewise, industrial production is expected to grow by 8% compared with 9.6% last year.

Nevertheless prospects remain bright once things pick up elsewhere: strong domestic investment - up 21% in 2001 and a big trade surplus - trade turnover in 2001 was $17.7 billion and is expected to increase by 7% this year - underpin the increasingly healthy economy.

The credit for fixing Kazakhstan's economy is largely National Bank of Kazakhstan (NBK) governor Grigory Marchenko's since he has pushed through reforms that other eastern European countries are still only thinking about.

Inflation stalks the former Soviet Union but Kazakhstan has largely slain this beast. Ossified economies mean raw material exports simply add to money supply and drive up inflation rates in most of the former Soviet states.

The NBK has tackled the problem on several fronts, but an oil stabilization fund - the National Fund - is the cornerstone of monetary policy. When oil prices are above $iq a barrel, excess revenues are automatically siphoned off to the fund. This enables the NBK to sterilize inflowing petrodollars and keep inflation under control while accumulating money that can be used to pay down debt or for investment.

The finance ministry has posted a small budget deficit target of about 1.5% a year, which mean that external debt remains at a modest 20% of GDP. Indeed Kazakhstan is a net creditor: total external debt is $3.8 billion but the NBK has reserves of $2.7 billion plus another $1.6 billion in the National Fund. Inflation has been held to between 5% and10% in recent years. And although the government doesn't need to borrow, the NBK continues to issue domestically traded bonds as a way of helping the commercial banking sector control its liquidity, a strategy that Marchenko says forms a "second line of defence against inflation".

With inflation under control the NBK has a monetary policy designed to boost exports. In theory the national currency, the tenge, floats freely and Kazakhstan has signed off on the IMF's article eight full convertibility clause.

In practice the NBK intervenes in the forex markets to gently push the tenge down against the rouble. Russia remains Kazakhstan's dominant trade partner and a lower tenge will help the competitiveness of Kazakhstan exports and reduce the trade deficit with Russia, which ran at $1.5 billion in 2001.

Patchy structural reform

Still there are problems. Despite have a strong claim to "best economy in the east" Kazakhstan is nowhere near winning the "best run country of the year" (see article on page 174). One of the ironies of Kazakhstan's solid economic reputation is the difference between the way the credit rating agencies see it and the assessment from export credit agencies such as Germany's Hermes and US Eximbank.

Although Kazakhstan enjoys a high BB rating - which implies that the macro-- economic situation is solid - the export credit agencies rate Kazakhstan as a category 6 country - a poor reliability rating. This is equivalent to a five-notch difference between the two types of rating - the biggest discrepancy in the world.

The macroeconomic situation may be shipshape, but structural reform remains patchy and political reform is going backwards. Too much of the economy remains concentrated in the hands of the president's family and surrounding clan.

The intertwining of political and corporate interests often leads to wrong-headed investment decisions and regularly ends in tears. The fear is that the current authoritarian regime is already making obvious mistakes.

A recent ABN Amro report on the Kazakh economy concluded: "What is being witnessed is that reforms are slowing and investment and credit extension are booming, while some discussion partners appeared to have a degree of (over-) confidence in the economy."

Banks run out of growing space

Kazakhstan can probably boast the best banking sector in the CIS (Commonwealth of Independent States). Strong economic growth and competition from the burgeoning pension fund sector has forced Kazakh banks to trim their fat and innovate in what is turning into a closely contested race to be best.

But the domestic banks are running out of growing room as they leave banks in surrounding countries behind. The leaders are already eyeing neighbouring markets in a search for fresh opportunities.

Recent strong economic growth has bolstered the health of Kazakhstan's financial sector's balance sheets, which tripled between the end of 1998 and 2001. Credit as a proportion of GDP grew from 12% a few years ago to 24% by the end of last year. And in two and half years total assets have more than doubled, loans have increased 3.5 times and household deposits have risen fourfold, thanks to a deposit insurance scheme.

But the republic's banks are still too small to cater for the leading industrial companies' appetite for cash. The sector's total assets are $5.5 billion - a tiny fraction of those of even one medium-size US bank. What's more, the top-three banks make up two-thirds of the total, about $i billion each.

There is not much that can be done about the banks' small size except to wait patiently for them to get bigger. In the meantime the National Bank of Kazakhstan (NBK) has been trying to solve the other problems.

"When we set out to reform the banking sector in 1995 we decided to create three distinct types of banks," says NBK chairman Grigory Marchenko. "At the top of the pile would be a few large retail banks with decent branch networks. Today three large retail banks compete with each other and another five medium-size banks. The next tier would be made up of foreign banks and joint ventures. Today we have 1i6, of which three - ABN Amro, HSBC and Citibank - are strong. Finally there would be a layer of small niche and regional players, which today make up the remaining 20."

With the main task of reforming the banking sector nearly completed the NBK has moved on to the other items on its todo list,

Marchenko's new pet projects include a boost to the mortgage business and a push to encourage banks to issue credit cards. Last year the NBK established the Kazakh Mortgage Company (KMC) with capital of $7 million. It is 40% owned by the NBK and 40% by private investors, with the rest held by the European Bank for Reconstruction Development and the International Finance Corporation.

The idea is that KMC will buy mortgages so banks can then refinance them by issuing mortgage-backed bonds. It would lower the interest rates and give investors another instrument to work with.

The NBK would also like to develop the insurance market, which has a tiny $100 million of assets. But here Kazakhstan's problem is that it is still tarred with the Russian brush.

"We have been talking to most of the big international players but most say that while Kazakhstan is interesting, until they have some positive results in Russia we will have to wait," says Marchenko.

And plans to develop the stock market have fallen flat. Kazakhstan has a bourse, but because of the corruption and strong role politics play in doing business, few companies are willing to loosen their control by floating shares.

The fixed-income market is more vibrant. The government has issued several well-- received Eurobonds and the corporate bond market has been developing rapidly, with about $570 million of paper in play at the moment. In May Kazkommertsbank (KKB) issued a $iSo million Eurobond bearing a relatively high 10.375% coupon. This followed national oil and gas pipeline operator TransNefteGaz's $250 million Eurobond issue last summer - the republic's first ever corporate Eurobond.

The NBK strictly regulates the running of local banks, which will all have to report accounts using international standards by the start of next year. However, the sheer pace of the financial sector's "explosive growth", as Marchenko calls it, means that caution is still advisable.

"Rapid economic growth paired with [far] more rapid expansion of the financial sector is a pattern which has been seen in the mid-to late 1990s in countries such as Thailand, Indonesia and Russia, all of which cases ended in financial disaster," Dutch bank ABN Amro concluded in a recent report on Kazakhstan's banks.

Few opportunities to lend

Kazakh banks have almost too much money and are struggling to find profitable investments domestically - so much so that the NBK is thinking about lifting restrictions on investments abroad.

Domestic liquidity has been boosted by two recent developments. A mandatory pension savings system was introduced in 1998 whereby 10% of employees' wages are put in pension funds. More than $1 billion is now under the management of pension funds, which are adding about $30 million a month to the total. And last year a general capital-flight amnesty was announced. An extra $500,000 returned home, with no questions asked.

Interbank overnight interest rates have fallen to the point where they are now negative in real terms, while, thanks to competition, banks are paying out up to 15% on deposit accounts: the pressure on the banks to lend money is high and growing.

The leading banks say they have more money than projects in which to invest.

"The harsh attitude of the tax authorities and the formal regulation of the NBK means that we need to innovate to fit the local environment," says Eldar Abdrazakov, managing director of Kazkommertsbank (KKB). "To continue our growth we are thinking about moving into Russia."

Abdrazakov points out that three-- quarters of GDP is generated by three sectors - metallurgy, hydrocarbons and power - which each contain only a few companies.

Continued economic growth will dilute this problem over time and the NBK is keeping a careful eye on the banks in the meantime to curb their more prodigal tendencies. The liquidity overhang is worrying but even another financial crisis would not be a disaster for the country.

With so much money stashed away by the government, it could currently assume the liabilities of the entire sector without much effort.
